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Technical Report

Interest Rates and Domestic Government Debt: The Outlook

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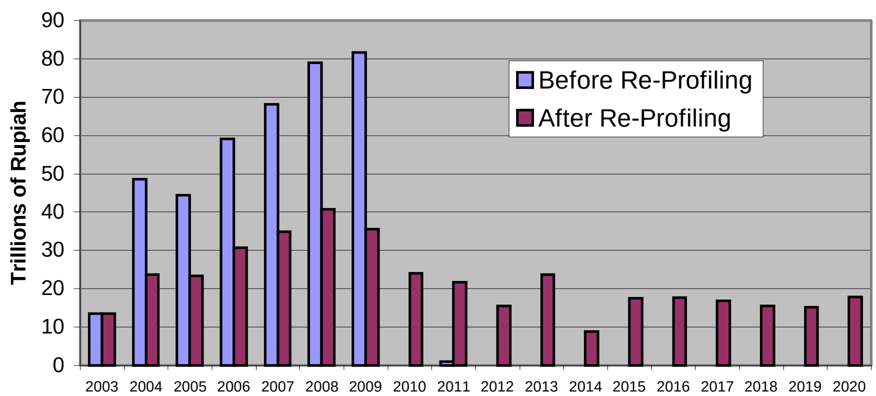
Interest Rates and Domestic Government Debt: The Outlook

During the crisis of 1997/98, the Indonesian government took on major amounts of domestic debt, most of which had a very compressed maturity structure. To alleviate this problem, the so-called 're-profiling' exercise of late 2002 was a major step forward.[2] It significantly lengthened the maturity structure of the debt, it filled in some gaps; and it eased the pressure for re-financing in 2004 (Figure 1).

Figure 1: Re-Profiling of Recap Bonds



Outstanding amounts of government bonds (fixed and variable rates bonds, FR and VR) dwarf corporate bonds in Indonesia. By way of example in this regard, as of late April 2003, VR and FR bonds totaled Rp390.7 trillion; at end-April, total corporate bonds were near Rp22 trillion.

However, gross annual issuances of bonds present a different picture, because the maturity structure of government bonds in now quite long (see Figure 1) vs. 3-5 years for corporate bonds. Also, the stock of corporate bonds is increasing whereas government bonds has been declining, *albeit* slowly. For example, gross new issues of corporate bonds in 2003 could be roughly Rp 20 trillion (an exceptional year by historical standards), compared with about Rp 8 trillion for the government, assuming that all maturing issues are rolled-over. Looking beyond 2003, the amount of government

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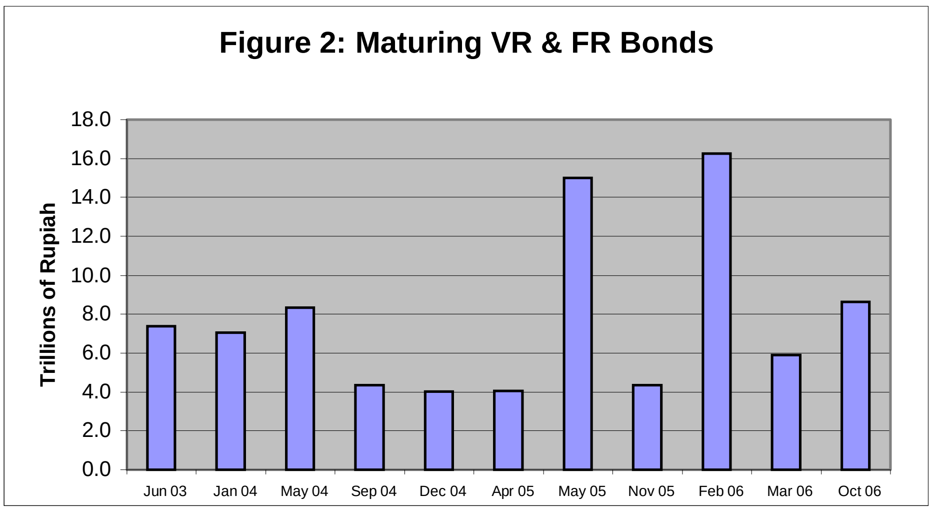
[2] This step was effectively a pre-emotive, partial rescheduling. Approved by Parliament on November 11 and implemented on November 20 2002, state bank holdings of some Rp172 trillion in recap bonds (with maturities 2004-09) were returned to the government in exchange for bonds maturing 2010-2020. For financial neutrality, the net present value of the new bonds was intended to equal the net present value of the old bonds. The new bonds are known as T-bonds. They are to be contrasted with T-bills, which would be of much shorter maturity.

rollovers is currently scheduled to increase to roughly Rp 25 trillion *per annum* (see Figure 1), which will probably exceed gross corporate issues.

Rates on rupiah bonds currently cover a wide range. At the lower end, are government bonds and the better corporates, which were yielding 12 ½% to 14 ½% in early June. At the higher end, a few corporate bonds were yielding as high as 16-18%.[3] All these rates are well below comparable financing at commercial banks.

Up-Coming Pressure Points

Looking at the earlier end of the maturity profile, there are some clear up-coming peaks in maturing issues within the next 2 years (see Figure 2). These are the points at which interest rate pressures could develop from this source.



Neither the June 2003 nor January 2004 maturities appear to be a problem at present. The first problematic maturity could be May 2004 when the Budget might be tight due to election spending and the end of Paris Club reschedulings. But more clearly, May 2005[4] and February 2006 stand out as large maturities that will probably be difficult to re-finance. Moreover, each of these is backed up against another, smaller maturity (April 2005 and March 2006) that magnifies the problem.

[3] Rates on US$ bonds generally ranged from 5-9%. In the case of Bank Mandiri, it's borrowing in US$ at about 5-6% and on-lending to Indonesian corporates at about 9%. Despite this high level of real rate, there seems to be strong demand because foreign banks are still reluctant to lend to Indonesian corporates. Also, Bank Mandiri may have been borrowing to meet payments under the Frankfurt Agreement (Exchange Offer). There has been strong foreign interest in holding these bonds because there is no exchange rate risk, and the best names (Telekom, Bank Mandiri, etc.) effectively carry a government guarantee.

[4] This is actually three maturities of fixed rate bonds, FR0003, FR0008 and FR0009, carrying interest rates of 12%, 16 ½% and 10%, respectively.

Various means are available to resolve this problem.[5] In the context of this paper, one useful approach would be to issue new, long-term bonds (of maturity 10 years or more) when the market is strong and use the proceeds to buy-back the 2005 and 2006 maturities, especially at the pressure points noted above. Another possibility would be to exploit the credit rating of the top state enterprises (for example, PT Telkom), by using their borrowings to pre-pay that corporations' debts to the government, allowing the government to pre-pay more recap bonds.

MoF officials understand these issues very well, and plan to undertake a 'debt switching' program later in 2004.[6] It would be voluntary and market-based; current bondholders would be offered an attractively priced T-bond (with a long maturity) for specific series of maturing issues. Success with T-bonds (FR0021 and FR0022) has been striking to date, as they have proved more popular then the recap bonds.[7]

Current Opportunities in the Market

As noted, the bond market is currently very active, with new issuances running at an all-time high. For 2003 as a whole, some financial houses are expecting to see Rp20 trillion in new corporate bond issues, and many issues have been heavily over-subscribed. In addition, the Budget makes provision for about Rp7 ½ trillion in rollover financing for government securities.

Corporates are expecting that this market will fade as political uncertainty increases with the approach of the 2004 election. Likewise, continuing interest rate declines have strengthened expectations of lower rates in the future, which raises bond prices. Rates on bonds are already well below bank lending rates, the traditional domestic financing source for Indonesian corporates.

Still a Thin Market That's Easily Spooked

There is evidence that Indonesia's bond market has become significantly more liquid in the past year or so. However, amounts traded are still only moderate (roughly Rp15 trillion per month), and the bulk of these appear to be less than arm's-length transactions, between banks and their mutual fund subsidiaries. Consequently, genuine trades are probably of the order of only Rp5-10 trillion per month.

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[5] These include using surplus (or accumulated) cash to pre-pay the maturities; another forced re-profiling exercise, if the bonds are held by agreeable parties (for example, state banks or their subsidiaries that manage mutual funds); and, as a last resort, forced rollovers.

[6] It would supplement the buyback program that uses the proceeds of IBRA asset sales.

[7] For instance, their prices have increased steadily, in part because their supply in the market is still relatively fixed. By contrast, the supply of recap bonds is more elastic.

In a bond market as thin as this one, any sizable disturbance could easily disrupt the market. For example, a corporate default could cause bondholders to sell their assets; any substantial amount of additional sales would cause prices to drop and interest rates to jump.

Impact on Interest Rates

Anticipated rollovers of government bonds would have limited impact on bond prices and interest rates, as long as the market is stable, maturities are small relative to market size, and pricing is market-based. This is partly because the maturing issue provides its own liquidity for the purchase of the new issue. Pressures on interest rates would only tend to develop when the maturities are large (see Figure 2) or if the market were to soften significantly (see previous Sub-Section). 'Crowding out' and liquidity/rollover risk are the extreme cases of complications in this area (see later in this Sub-Section).

Given the current appetite for T-bonds (including relative to recap bonds), it would be relatively easy for the government to issue, say, 5-10 trillion in T-bonds in 2003. If the issuance were timed to match the maturity of smaller issuances (in say June 2003 or January 2004) the market would be relatively liquidity, making it easier to price the issue attractively.

Looking beyond 2003, various sources of upward pressure on rates seem likely to arise at different points in time. For example, general pressure on interest rates could develop in 2004, due to rising macroeconomic uncertainty as the elections approach. In 2005, maturing government issues could dominate the market, forcing the government into competition with the private sector for the available funds. Viewing the problem from a different perspective, the rapid growth in mutual funds has raised a new range of risks that are discussed in a separate note. Pressure from this side could trigger selling of bonds, causing bond prices to drop and interest rates to climb.

Turning to the topic of crowding out,[8] it seems unlikely that this will be much of an issue in the near term, because the market is currently so strong. However, looking further ahead, when government rollovers exceed corporate new issues, it is easy to imagine demand for bonds weakening, and the government having to price a rollover issue high enough to out-bid the corporates.

A more extreme case concerns the situation where the market becomes so illiquid that the government cannot rollover a maturing issue, at any price. This was the case, for example, for almost all Indonesian corporates during the crisis of 1997/98. To minimize this risk, the government should smooth out the peaks in its profile of maturities (see Figure 2); lengthen the average maturity (see following Sub-Section); and use market opportunities—like the present—to buy back its own debt at selective maturities.

[8] 'Crowding out' should be understood to mean the government pre-empting the corporate sector in bidding for the available financing in the market.

The T-Bill Issue

Another possibility appears to be raising financing through the issuance T-bills (government liabilities of maturity 1 year or less). From the point of view of debt management this would be an undesirable step because it boosts relatively short-term debt, thereby increasing rollover risk, especially around the time of major maturities (like May 2005).

Recommendations

In order to reduce interest rate risk during periods of heavy government bond maturities, recommended steps are:

- Use debt buybacks and debt switching to smooth out the peaks in the maturity structure of the debt.
- Issue additional long-term debt during strong periods of the bond market (like the present), and use the proceeds to buy back selective maturing issues.
- Ask the top state enterprises to pre-pay their debts to the government and use those proceeds to retire more recap bonds.
- Delay the issuance of T-Bills until the sharpest peaks in the maturity profile have been smoothed out (or the peaks have passed).
- Maintain strong institutional capacity in the MOF's Debt Management Unit. And,
- Convince the DPR of the benefits of pro-active debt management, including the points noted above.